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Article — Published Version

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Intereconomics

Suggested Citation: Frenkel, Michael; Fendel, Ralf (2003) : The new ECB voting system: Some room for improvement, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 38, Iss. 6, pp. 334-338

This Version is available at:
https://hdl.handle.net/10419/41734

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The New ECB Voting System: Some Room for Improvement

In order to overcome the "numbers problem", the ECB recently proposed a weighted rotation system that limits the number of votes to at most 21. Many academics heavily criticise the proposal. Besides very fundamental criticism the composite indicator that allocates national central banks into the voting groups has especially been called into question. Its implementation would cause some conflicts concerning procedure and in connection with the discretionary elements of the ECB proposal.

The decision in favour of rapid enlargement of the European Union (EU) starting in May 2004 has been taken. Since there will be no "opting out clause" for the potential new EU members, they will sooner or later also join the European Monetary Union (EMU). The precise entry dates will depend on political factors as well as on individual compliance with the Maastricht criteria. Given this prospect, the current decision-making process of the European Central Bank (ECB) will no longer be viable.

On December 20, 2002, the ECB itself published details of a proposal for a new voting system. This proposal was unanimously approved by the Governing Council of the ECB on February 3, 2003.[1] The ECB's recommendation is based on Article 10.6 of the Statute of the ESCB introduced by the Treaty of Nice, which entered into force on February 1, 2003. It has already been submitted to the EU Council and the latter, meeting in the composition of heads of state or government on March 21, 2003, decided to adopt the recommendation of the ECB.[2] The agreed amendment is proposed to the member states for ratification in accordance with their respective constitutional requirements.

The Fundamental Trade-off

The accession process has two problematical characteristics. Firstly, its precise speed is unknown at present. Secondly, the accession process is highly asymmetric because the majority of the acceding countries are small in size and economic power compared to the current EMU average.

Given the characteristics of the accession process, the ECB faces a potential trade-off between the efficiency of its decision-making process and the adequate representation of euro area member states. Efficiency would be best ensured by two main measures:

- limiting the size of the Governing Council of the ECB to a viable number of members
- strengthening the number of members of the Executive Board of the ECB to preserve the euro area-wide view in decision-making as demanded by the ECB Statutes.

Both measures, however, are at odds with the wish to adequately represent all euro area member states within the Governing Council of the ECB, which in its extreme would require the full participation of all national governors. Even if the limitation of the voting power of national governors is accepted in principle, a second question necessarily arises: which indicator would be the most valid (i.e. the most representative) for the allocation of the limited voting rights.

The ECB's Proposal

In order to maintain the Governing Council's capacity for efficient and timely decision-making as its membership increases substantially, the Governing Council agreed that the number of governors of the national central banks exercising their voting right should not exceed fifteen at any stage of the EMU enlargement process or thereafter.[3] Should this threshold be reached in the process of accession, i.e. with the fourth new EMU member state, the Governing Council

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[1] European Central Bank: Governing Council formally recommends new voting system, press release of Feb. 4, 2003.

[2] Council of the European Union in the composition of Heads of State or Government: Document 7433/03, Brussels, March 21, 2003.

Table 1
An Illustrative Example of the Voting Allocation in an EMU-22 Case[1]

Rank	Country	Composite Indicator	Number of Votes
1	Germany	29.33 %	
2	France	20.46 %	
3	Italy	15.67 %	4 Votes
4	Spain	8.67 %	
5	Netherlands	6.04 %	
6	Belgium	3.62 %	
7	Austria	2.91 %	
8	Poland	2.36 %	
9	Finland	2.09 %	
10	Portugal	1.72 %	
11	Greece	1.65 %	8 Votes
12	Ireland	1.51 %	
13	Luxembourg	0.92 %	
14	Czech Rep.	0.82 %	
15	Hungary	0.70 %	
16	Romania	0.52 %	
17	Slovakia	0.26 %	
18	Slovenia	0.24 %	
19	Bulgaria	0.18 %	3 Votes
20	Lithuania	0.16 %	
21	Latvia	0.10 %	
22	Estonia	0.07 %	

[1] In the future, when the rules actually become applicable, the data for the calculation of the shares in GDP at market prices will be provided by the European Commission. The data for the calculation of the shares in the TABS-MFI will be defined and provided by the ECB on the basis of Council Regulation (EC) No. 2533/98 of 23 November 1998 concerning the collection of statistical information by the ECB. This regulation is of course not binding for the accession countries until they enter the EU.

Sources: ECB, EU-Commission, IMF and Handelsblatt.

of the ECB will start to apply a rotating voting system based on voting groups.

The number of voting groups will be adjusted throughout the accession process. When the EMU comprises 16 to 21 member states, there will be two voting groups and once there are 22 or more member states, there will be three voting groups.

The principal component of the composite indicator that is responsible for the allocation of member states into different groups will be their gross domestic product (GDP). This component will have a relative weight of 5/6 within the indicator. The second component, with the remaining weight of 1/6, will be the total assets of the aggregated balance sheet of the Monetary Financial Institutions (TABS-MFI) within the territory of the member states.

[3] European Central Bank: The adjustment of the voting modalities in the Governing Council 120, in: ECB Monthly Bulletin, May 2003, pp. 73- 83.

Table 1 provides a hypothetical example based on the proposed indicator for an EMU-22 case where it is assumed that the EU members United Kingdom, Denmark and Sweden as well as Malta and Cyprus do not join EMU.[4]

The estimates in Table 1 indicate that unless the UK, Denmark, and Sweden join EMU, only Poland will move into the ranks of the current 12 euro area members. If the UK joins EMU, the Netherlands will drop out of the first group. Sweden and Denmark are likely to find themselves in the second group. However, in particular the TABS-MFI component is likely to exhibit quite a dynamic development in the accession countries, so that any estimates of the composite indicator made today have only a limited relevance, since it will be several years until the new voting modalities under the three-group regime are applied for the first time.

The proposal of the ECB has been heavily criticised.[5] The critics can be divided into two groups. The first consists of fundamental critics. They dismiss the proposal absolutely and argue in favour of alternatives. The second group seems to accept the proposal in principle but criticises some specific failures within it.

The Fundamental Criticism

The fundamentalist critics state that the proposed rotation system is inefficient, non-transparent, internally inconsistent and arbitrary.[6] They argue that such a rotation model is not sustainable.[7] One of their main points here is that the decision-making body is too large. The history of prominent central banks with respect to the degree of centralisation is used to support this view.

In strong contrast to the direction of the ECB proposal, the German Bundesbank and the US Fed have both systematically reduced the political weight of regional representatives in their Council over time.[8] Early in their history, both central banks were formed more or less as unions of regional or national central

[4] This hypothetical case is in no respect any judgment on the expected accession process and the choices of the UK, Denmark and Sweden. In fact, this selection was made due to data limitations. This is also the reason why different authors come up with slightly different orders (see for example D. Gros: An Opportunity Missed, in: INTERECONOMICS, Vol. 38, No. 3, May/June 2003, pp. 124-129.

[5] See for instance the discussion in INTERECONOMICS, Vol. 38, No. 3, May/June 2003.

[6] See for example D. Gros, op. cit.

[7] See A. Belke: The Rotation Model is not Sustainable, in: INTERECONOMICS, Vol. 38, No. 3, May/June 2003, pp. 119-124.

[8] See H. Berger: The ECB and Euro-Area Enlargement, IMF Working Paper, WP/02/175, pp.10ff.

Table 2
Distribution of Voting Power in Selected Central Banks

	Size of Board	Regional Central Bank Votes	Overall Council Votes	Political Weight of Governors
Bundesbank after 1992	8	9	17	52.9 %
Federal Reserve	7	5	12	41.7 %
ECB 2003	6	12	18	66.7 %
ECB proposal after accession	6	15	21	71.4 %

Sources: Central banks and own calculations.

banks (in the case of the Bundesbank these were the "Landeszentralbanken"). However, over time, the central elements in their decision-making body were systematically strengthened.

Beside this strengthening of the "central votes", the Bundesbank and the Fed also constrained their decision-making bodies due to the high decision–making costs associated with growing Councils. The Federal Open Market Committee actually consists of 12 members, of which 7 are Board members and 5 (rotating) are regional central bank governors.[9]

In the case of the Bundesbank, the reform in 1992 after German unification was designed to ensure that the number of the Landeszentralbanken would not translate into a larger overall Council. At that time, without the institutional reform of merging the Landeszentralbanken, the Bundesbank Council would have increased to 26, a number that comes close to the proposed 21 votes of the Governing Council of the ECB. According to the Bundesbank, this number "would have greatly complicated that body's decision-making process".[10] Table 2 gives a comparative overview of historical, current and intended relative voting powers.

The weakening of the Executive Board's position might be mitigated by two additional effects. First, while the NCBs are strengthened as a group, they lose power on an individual basis. Second, the procedural practice of the Governing Council of the ECB, according to which the chief economist, who is always an Executive Board member, sets the agenda and makes specific proposals, potentially strengthens the Board and its euro area-wide perspective in the Council if, as has been the case up to now, decision-making is based on consensus.[11]

However, the fundamental critics argue for a more centralised approach to the reform. In particular, they propose a new division of responsibilities between the Governing Council and the Executive Board.[12] According to their proposal, the latter should be redefined as an independent body within the monetary policy decision-making process and should be solely responsible for interest-rate decisions to meet the goal of price stability. The Governing Council consisting of all national governors should instead meet less frequently. It should be responsible for strategic decisions and would supervise the Executive Board.

Though this proposal might be very reasonable, it is questionable whether either the old or the new members of the EMU are ready to accept such a loss of power. Additionally, it seems likely that such a change would create a new problem in the form of a considerably more complicated process for appointing new members of the Executive Board. It can be expected that the replacement of Executive Board positions will become even more of a political issue than it already is today.

Realistically, it must be admitted that the EMU is not yet ready for such a high degree of centralisation. It is likely that this proposal, though preferable, will not find a majority among EMU members. A higher degree of centralisation can only be reached through an evolutionary learning process. Thus for the time being only less ambitious structural reforms like the ECB proposal are able to find majority approval. Nevertheless, even within this proposal there is room for improvement.

The Case Against the Composite Indicator

Within the ECB proposal the composite indicator, which is the basis for the ranking and grouping of countries, can be criticised. Several questions concerning the composite indicator arise. For example, should the financial sector explicitly be accounted for? The financial sector is a fundamental part of the transmission process of monetary policy. To a certain ex-

[9] For details in the case of the Fed see B. Eichengreen: Designing a Central Bank for Europe: A Cautionary Tale from the Early Years of the Federal Reserve System, in: M. Canzoneri, V. Grilli, R. Masson (eds.): Establishing a Central Bank in Europe and Lessons from the US, Cambridge 1992, pp. 13-40. The ECB itself draws parallels to the Fed: "It can be noted that the new voting system is similar to the one used in the Federal Open Market Committee in the United States, …" (ECB, op. cit., p.83).

[10] Deutsche Bundesbank: Restructuring the Bundesbank, in: Monthly Report, August 1992, p. 50.

[11] For this argument see M. Brückner, J. von Hagen: Monetary Policy in Unknown Territory, The European Central Bank in the Early Years, ZEI Discussion Paper B18, 2001.

[12] See for details D. Gros, op. cit., and A. Belke, op. cit.

Table 3
Percentage Share in the EU MFI Sector by Country
(end 2002)

Rank	Country	Share in %
1	Germany	26 %
2	France	17 %
3	Italy	9 %
	Austria	9 %
5	Luxembourg	6 %
	Netherlands	6 %
	Spain	6 %
8	United Kingdom	5 %
9	Finland	4 %
10	Sweden	3 %
	Ireland	3 %
12	Denmark	2 %
	Portugal	2 %
14	Greece	1 %
	Belgium	1 %

Source: ECB.

tent, the size of the financial sector is a crucial variable for conducting monetary policy, but qualitative rather than quantitative aspects might be more important for the transmission process of monetary policy.

Even if it is accepted that the financial market size should somehow be represented, an additional question is whether the indicator TABS-MFI reflects this size correctly. According to the official definition of the ECB, "monetary financial institutions (MFIs) are central banks, resident credit institutions as defined in community law, money market funds, and other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credits and/or make investments in securities".

By the end of 2002, the share of the assets of credit institutions in the total assets of MFI was 81.8%, and money market funds accounted for 17.9%. Other institutions and the central banks only accounted for 0.1% and 0.2% respectively. However, the TABS-MFI does not reflect the whole financial sector and is biased to the particular segment of banks within the financial sector. Its usage necessarily translates into a bias for those countries with a large banking sector. These countries are not necessarily those with large overall financial sectors that the indicator is intended to reflect. Table 3 shows the share of the EU MFI sector by country.

As Table 3 indicates, Luxembourg for example has a higher share than the potential member UK and the same share as Spain and the Netherlands. These figures illustrate that the TABS-MFI hardly represents the importance of financial markets within the EU due to the different structures in several countries. Countries with a large but more diversified financial market such as the UK will clearly be underrepresented.

A further question in the context of the composite indicator is whether the TABS-MFI component creates a lack of transparency for the ranking of member countries. This could be the case for several reasons. The weight of 1/6 for the TABS-MFI lacks an elementary justification and thus seems to be rather arbitrary. As already mentioned above, the TABS-MFI component of the composite indicator is likely to be exposed to substantial momentum in the coming years, especially in the accession countries. This, in turn, may cause fairly frequent redefinitions of the voting groups, which also contributes to intransparency. It could also contribute to ongoing conflicts between members as well as to ongoing discussions about the appropriateness of the composite indicator.

The problems with the composite indicator raise the question whether there are alternative designs for the indicator. A one-dimensional indicator would lead to a higher degree of transparency in the allocation process of voting rights. Natural candidates are GDP and population size. Since monetary policy is concerned with the economic performance of the euro area, GDP would be the most intuitive indicator.

Taking the size of the population of a member state as an indicator can only be justified indirectly. Since – in the long run – plausible economic mechanisms are likely to lead to the catching up of poorer regions, i.e. a convergence in per capita production and income, the population size displays the potential future strength of the region. This may justify a composite indicator of current GDP and population size. An indicator with equal weights for these two variables would then mimic the procedure used to calculate the capital subscription of each country to the ECB.[13] Thus, in addition, this composite indicator would be consistent with already established practices.[14]

The arguments above suggest that the adequate provision of an indicator that captures the financial market calls for a more comprehensive variable than the TABS-MFI. The problem here is that no such sin-

[13] For the country ranking of alternative measures see E. Meade: A (Critical) Appraisal of the ECB's Voting Reform, in: INTERECONOMICS, Vol. 38, No. 3, May/June 2003, pp. 129-131.

[14] The use of this particular indicator also indirectly implies the popular and widely accepted saying, "The one who pays has the right to govern".

gle variable exists. Instead, the size, breadth and the overall importance of a financial market can only be appropriately captured by a composite indicator variable. This, in turn, would contribute to an even smaller degree of transparency in the overall composite indicator.

Procedural Conflicts and Discretionary Elements

While Table 1 shows a possible situation under the final regime of three groups, additional problems may arise during to the transition process if EMU increases by taking in one country at a time. The accession of relatively big countries like the UK or Poland will necessarily lead to drop-outs of medium-sized countries from the first to the second or from the second to the third group. This may cause conflicts during the accession process given that there are considerable discretionary margins in the interpretation of the Maastricht criteria and, thus, in the decision to accept new members. As in other areas, incumbent members may be tempted to defend their positions.

The proposal by the ECB also leaves some discretionary elements that could potentially cause additional trouble and conflicts. The most profound one is the lack of a definition of the rotation rules and frequencies within a group, which can also be seen as a major weakness of the proposal. The ECB should decide as soon as possible on these rules. Otherwise potential conflicts will arise. Take for example the question of the order of rotation. Several options exist: rotation in alphabetical order, rotation in order of size, shown again by the composite indicator, or rotation in order of accession. All modalities would cause some dispute and possible frictions.

Consider the example of an alphabetical rule for the voting order.[15] Suppose that, in the first group, the status quo is such that the Netherlands currently holds no voting right. Now, before the Netherlands receives a voting right within the first voting group, the UK joins and the Netherlands drops out of the first group. If, at the same time, Bulgaria, Cyprus, the Czech Republic and Estonia, to name just a few countries that rank ahead of the Netherlands with respect to alphabetical order, join, all of them are likely to be assigned to the second voting group. Who votes first in this case: the incumbent member or the new ones due to the alphabetical order? Depending on the exact sequence and timing of the accession process with an alphabetical order, it is possible that new members will receive voting power before incumbent ones.

[15] Remember that this principle is applied, for example, in the rotation of the EU presidency.

Other rules with regard to order would result in other specific shortcomings. It is hardly possible to get the potential side-effects under full control. As a consequence, this calls for a relatively high frequency of rotation at least during the transition process. As a side effect, this also strengthens the position of the Executive Board members within the Governing Council of the ECB.

Conclusions

The new voting scheme of the Governing Council of the ECB is characterised by a weakening of the Executive Board of the ECB with respect to its pure voting power. Whether this will be a problem depends on the preferences of regional governors and the degree of asymmetric developments within the euro area.

The lower degree of decentralisation together with the large number of Council members is at odds with the historical experience of the Federal Reserve System and the Deutsche Bundesbank. This decision seems to be mainly driven by a trade-off between political feasibility and efficiency. However, as a single "European identity" can be enforced in the future, we may see a trend toward more centralisation and towards a smaller decision-making body.

In this respect it would be reasonable simultaneously with the entry into force of the new voting system to define a fixed point in time at which it will be put to a general assessment, as was done for the ECB's monetary policy strategy. This fixed timing would provide the setting for further, more courageous, reformulation without the loss of credibility that would result from ad hoc assessments.

Because of its TABS-MFI component, the composite indicator is not transparent. This component also does not capture the financial market as a whole. Since this is hardly possible with a single variable, it is better not to include such a variable at all. This points to a one-dimensional GDP-based indicator as a first best solution. The second best would be to complement GDP with population size.

The identified dynamic weaknesses of the new voting system make accession in waves (as opposed to individual accession dates) more likely. With the accession of groups of countries, the adaptation of the new decision process seems more robust. Nevertheless, the Governing Council of the ECB should decide upon the precise rules of rotation within groups as soon as possible.